

Internal Revenue Service
memorandum

DFBergkuist
INTL-621-89

date: NOV-2 1989

to: William E. Bonano
International Special Trial Attorney (San Francisco)

from: Senior Technical Reviewer/ (CC:INTL)
Branch 4

subject: [REDACTED]

This is in response to a request for assistance, dated August 25, 1989, involving three issues included for trial in the above-named docketed case.

The specific issues that you have requested our assistance on are:

1. For purposes of allocating research and development expenses and calculating combined taxable income (CTI) under section 994 of the Internal Revenue Code, does the two-digit SIC code grouping rule of section 1.861-8(e)(3)(i)(A) override the "recognized industry or trade usage" grouping method permitted in section 1.994-1(c)(7), relating to the DISC intercompany pricing rules?
2. Does the exclusive apportionment rule of section 1.881-8(e)(3)(ii)(A) apply to the calculation of CTI for a commission DISC?
3. Does the research and development moratorium (ERTA section 223) apply to the calculation of CTI?

DISCUSSION

ISSUE 1

We are in agreement with your analysis of the issue. Section 1.994-1(c)(7) does, indeed, permit the election of a product grouping that includes a recognized industry or trade usage that is, presumably, more finite than a two-digit SIC grouping. However, as you have correctly noted, for purposes of calculating the combined taxable income of a DISC and its related supplier, section 1.994-1(c)(6)(iii) provides that costs (other than the cost of goods sold) which shall be treated as related to gross receipts from sales of export property are (a) the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto, and (b) a

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ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of income of gross income, determined in a manner consistent with the rules set forth in section 1.861-8.

Section 1.861-8(e)(3)(i)(A) provides that research and development expenditures deductible under section 174 shall ordinarily be considered deductions that are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and, therefore, are allocable to all items of gross income as a class related to such product category. For purposes of allocation, the product category (or categories) which a taxpayer may be considered to be limited to is derived from a list consisting of two-digit SIC major groups and such groupings may not be subdivided by the taxpayer.

Section 1.861-8(a)(3)(i)(A) also provides that the methods of allocation and apportionment for research and development recognize that research and development is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and development must bear the cost of unsuccessful research and development.

In addition, section 1.861-8(f)(1)(iii), as in effect for the years in question, provided, in part, that, pursuant to the regulation under section 994, section 1.861-8 provides rules for determining the deductions to be taken into account in determining combined taxable income, except as modified by the marginal costing rules set forth in the regulations under section 994(b)(2), if used by the taxpayer as provided therein.

The taxpayer did not use marginal costing. [REDACTED] and are all in the same two digit SIC major group of [REDACTED]. A recognized industry or trade usage grouping more restrictive than SIC group [REDACTED] is not relevant for the allocation of such indirect costs as research and development expenses. Although [REDACTED] was the only income producing product within SIC group [REDACTED], all research and development expenditures of the taxpayer relate to SIC group [REDACTED] and would properly be allocated to any income from this group.

Issue 2

For taxable years [REDACTED], [REDACTED], and [REDACTED], the taxpayer excluded amounts representing 30 percent of the respective year's research and development expenses from the calculation of CTI citing the application of section 1.861-8(e)(3)(ii)(A). This provision provides that for taxable years beginning after 1979, where apportionment based upon geographic sources is necessary, 30 percent of the deductions for research and development shall

be apportioned exclusively to U.S. sources if more than 50 percent of the research and development activities are conducted in the United States. In this case, all of the research and development activities were performed in the U.S. The taxpayer proceeded to apportion the remaining 70 percent between domestic and export sales based upon the ratio of gross receipts.

We agree with the examining agent's disallowance of the use of the exclusive apportionment described above. CTI does not require geographic sourcing and, as noted by the agent, Example 23 of section 1.861-8(g) is intended to highlight this point.

It is our view that the qualifying language of section 1.861-8(e)(2)(ii), "where an apportionment based upon geographic sources of income of a deduction for research and development is necessary...", is a threshold requirement that is not met with respect to the CTI calculation of a DISC and its related supplier. The CTI calculation is not dependent on geographic sourcing; it is merely a pricing calculation that requires apportionment of research and development expenses between the statutory grouping of gross income from exports and other gross income.

The fact that Example 23 involves a buy/sell DISC rather than a commission DISC is immaterial. While the determination of CTI may indirectly affect the amount of foreign source income arising from the DISC's deemed or actual distributions and thus the calculation of the foreign tax credit, this indirect effect does not, in any sense, place the separate CTI calculation within the geographic sourcing language of section 1.861-8(e)(3)(iii).

As previously discussed with you in various telephone conversations, there appears to be no additional legislative, administrative, or case authority on this issue and we have already sent you copies of all background materials in our possession. It is our view that Example 23 should be read to stand for the general position that CTI does not involve a geographic sourcing calculation and, as a result, title passage and buy/sell or commission status of the DISC will not affect its application.

Issue 3

The taxpayer is questioning the validity of Rev. Rul. 86-144, 1986-2 C.B. 101, that provides that the moratorium on research and development allocation, enacted as part of ERTA in 1981 and extended by TRA in 1984, does not apply to the calculation of CTI.

The position taken in Rev. Rul. 86-144 is still our position. While the legislative history of section 223 of ERTA does not specifically discuss this issue, the Committee language

concerning section 126 of TRA of 1984 clearly states that the moratorium does not apply to CTI calculations and that the moratorium was extended by this provision of TRA of 1984.

As noted in Rev. Rul. 86-144, the moratorium revised the allocation and apportionment of research and development expenses in order to modify the calculation of foreign source taxable income and, accordingly, to adjust the foreign tax credit limitation. Example 23 of section 1.861-8(g) demonstrates that, for purposes of section 1.861-8, research and development expenses are allocated and apportioned in two stages. In stage one, research and development expenses are apportioned to calculate CTI for DISC purposes by treating the DISC and its related supplier as a single taxpayer. In step two, research and development expenses are apportioned for purposes of calculating the foreign tax credit limitation under section 904. It is clear that geographic sourcing of income is required for purposes of calculating the foreign tax credit limitation but not for calculating CTI.

Your memo indicates that the taxpayer is relying on certain heresay information and irrelevant legislative history to reach a conclusion contrary to the holding in Rev. Rul. 86-144. We also find that these authorities to be unpersuasive.

We hope that this will be helpful to you in preparing your case for litigation. You may to contact David Bergkuist of this office on FTS 566-3872 for additional information or assistance. As noted above, we have already furnished you with copies of all pertinent materials in our files that relate to the issues under consideration for litigation in this case.

cc: Kim Palmerino